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IN THE

# Supreme Court of the United States

October Term, 1973

No. ..... 73-247

LAWRENCE HOLZMAN, Trustee in Bankruptcy,

*Petitioner,*

*vs.*

L.H.J. ENTERPRISES, INC.,

*Respondent.*

**Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.**

CHARLES J. KATZ,
3550 Wilshire Boulevard,
Suite 1720,
Los Angeles, Calif. 90010,
*Attorney for Petitioner.*

KATZ, HOYT & BELL,
LUCE, FORWARD, HAMILTON &
SCRIPPS,
*Of Counsel.*

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IN THE

# Supreme Court of the United States

October Term, 1973
No. .....

LAWRENCE HOLZMAN, Trustee in Bankruptcy,

*Petitioner,*

*vs.*

L.H.J. ENTERPRISES, INC.,

*Respondent.*

**Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.**

The Petitioner, Lawrence Holzman, Trustee in Bankruptcy for Pasqual Patrick Piro, Jr., aka Pat Piro, individually, and doing business as Boy's Towne, Bankrupt, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit entered in this proceeding on April 5, 1973.

## Opinions Below.

The opinion of the Court of Appeals, not yet reported, appears in the Appendix as A hereto. The opinion of the District Court for the Southern District of California appears in the Appendix as B hereto.

**Jurisdiction.**

The Judgment of the Court of Appeals was entered on April 5, 1973. A due and timely Petition for Rehearing was denied on June 15, 1973, and a suggestion for rehearing *en banc* made with the aforesaid Petition for Rehearing was rejected at the same time. A copy of the Order denying the Petition for Rehearing and rejecting the suggestion for a rehearing *en banc* appears as C in the annexed Appendix. This Court's jurisdiction is invoked under 11 United States Code §47; (Section 24(c) of the Bankruptcy Act, as amended, through December 31, 1966).

**Questions Presented.**

1. Whether under the new Commercial Code of California, a lien (there called a "purchase money security interest") upon the after-acquired inventory of a bankrupt retail merchant, is valid as against his trustee in bankruptcy where the secured party is neither the seller of, nor the lender financing the purchase of, that after-acquired inventory.

2. Whether, as against a trustee in bankruptcy, such a general roving purchase money security interest (lien) upon the *proceeds* of the after-acquired inventory of a retail merchant, is valid in the setting of a filed financing statement which does *not* disclose, upon its face, that the secured creditor specifically claims a lien upon the *proceeds* of any such *after-acquired* inventory?

3. Whether, as here construed, and here applied, Section 9102(4) of the California Commercial Code read together with Section 9108 of that Code irreconcilably collides with the paramount provisions of Section 60 (the voidable preferential transfer section) of the Bankruptcy Act?

**Statutory Provisions Involved.**

The provisions of Section 9102(4) of the Commercial Code of the State of California are:

> "Notwithstanding anything to the contrary in this division, no nonpossessory security interest, other than a purchase money security interest, may be given or taken in or to the inventory of a retail merchant held for sale, except in or to inventory consisting of durable goods having a unit retail value of at least five hundred dollars ($500) or motor vehicles, house trailers, trailers, semi-trailers, farm and construction machinery and repair parts thereof, or aircraft."

[The latter portion of the statute commencing with the phrase "except in or to inventory consisting of *durable* goods having a unit retail value of at least ($500) . . ." [Emphasis added] is not really here directly involved, for the bankrupt was a retail seller of boys clothing—and that could scarcely be considered "*durable*" goods.]

The provisions of Section 9108 of the Commercial Code are:

> §9108. When After-Acquired Collateral Not Security for Antecedent Debt. Where a secured party makes an advance, incurs an obligation, releases a perfected security interest, or otherwise gives new value which is to be secured in whole or in part by afteracquired property his security interest in the afteracquired collateral shall be deemed to be taken for new value and not as security for an antecedent debt if the debtor acquires his rights in such collateral either in the ordinary course of his business or under a contract of purchase made pursuant to the security agreement within a reasonable time after new value is given. (Stats. 1963, c. 819, § 9108.)"

**Statement of the Case.**

There is no dispute as to any of the facts. The cause was tried below on a "Stipulated Statement of Facts for Review" which is designated E in the Appendix hereto. The undisputed facts are these:

The bankrupt was a retail merchant of boys' clothing in San Diego, California. On July 20, 1966 he bought an original inventory of boys' clothing and retail store fixtures from respondent, giving back a note evidencing a portion of that purchase price; and, to secure that note a security agreement was signed [TR 15] giving respondent a "purchase money security interest" in all of the inventory of boys' clothing and the therein specifically designated fixtures; and, in: "any and all additions, accessions and substitutions thereto and therefor."

A financing statement (Appendix F hereto) was then filed in the office of the Secretary of State of California [TR 24]. It recites:

> "This financing statement covers the following types of property (. . .); inventory of boys' clothing now and hereafter contained in the premises."

The financing statement so filed [TR 24] expressly *does not cover the proceeds* of any collateral. As appears on the face of the financing statement, provisions are there made, (on the form of financing statement prescribed by the Secretary of State of California) for the secured party and debtor to declare and expressly to disclose whether the secured party claims that "Proceeds of Collateral are also covered." This is

done by the secured party so indicating by placing a check mark in the box found on the form alongside the printed phrase "Proceeds of Collateral are also covered". Both the respondent secured party and the debtor expressly failed to indicate that the "Proceeds of Collateral are also covered" upon the face of their filed financing statement [TR 24].

In the intervening years between July 20, 1966 (the date of respondent's sale to the bankrupt) and March 10, 1970 (the date of the voluntary adjudication in bankruptcy) the bankrupt made substantial purchases from other vendors, (now unpaid general creditors herein) of different inventory goods than those goods which had formed the original inventory sold by the Appellee to the bankrupt. By their Stipulation of Fact, the parties agreed that only $500.00 in value of the 1966 inventory was on hand in 1970 [TR 11]. The Trustee in 1970 sold the bankrupt's inventory for more than $4,143.92 plus interest; that was the amount still owing appellee in 1970 on his 1966 indebtedness. Believing appellee to have a valid purchase money security in all the proceeds of that after-acquired inventory, the District Court awarded the appellee the full amount of its indebtedness out of the Receiver's sales proceeds, rather than allowing appellee only $500.00, the value of the remainder of the original inventory which appellee had first sold to the bankrupt. The Court of Appeals affirmed.

## REASONS FOR GRANTING THE WRIT.

### I.

(a) The Circuit Court has upheld as valid in the State of California a roving lien upon the proceeds of the after-acquired inventory of a retail merchant of boys' clothing and as against the Trustee in Bankruptcy of that retail merchant. It has done so in asserted reliance upon the provisions of a newly enacted statute, Section 9102(4) of the Uniform Commercial Code, first adopted in California on January 1, 1965. California is the only State with a statutory provision similar to California Commercial Code Section 9102(4), out of all the States which have adopted the Uniform Commercial Code.[1]

The case is of first impression in the field of commercial and bankruptcy law. California is today the leading, (or at least one of the leading) states, in the area of commercial activities involving thousands of creditors and their many debtors operating countless retail stores in the state; these sales-upon-credit transactions generate a countless myriad of general unsecured creditors who supply such retail merchants with the ever-changing mass of goods which today comprise the variegated inventory of retail merchants.

As can be seen from the text of the annexed decision, the opinion of the Ninth Circuit is exceedingly

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[1]The Uniform Commercial Code was nationally sponsored by the National Conference of Commissioners on Uniform Laws and the American Law Institute. It has now been adopted in at least 27 states, and in every State with significant commercial practices and substantial debtor-creditor relationships.

brief, (considering the complexity and importance of the problem) and the opinion apparently was reached by the Court from its own reading and interpretation of the face of the statute for no supportive authorities are set out in that opinion.

The statute, Commercial Code 9102(4), proscribes and interdicts all *non-possessory inventory liens* upon nondurable goods of a retail merchant, *except one taken or given to secure a "purchase money security interest."* As we shall hope to demonstrate to this Court, it is critically necessary for the guidance of creditors and retail merchant debtors alike that there be a final interpretation of precisely what, in the context of this new statute, constitutes such a "purchase money security interest", so that such vendors of nondurable inventory goods may know when they may, and when they may not, safely extend credit to retail merchants. Equally important is a determination by this Court of when a secured creditor may, consistent with the new Uniform Commercial Code, successfully lay claim to the "proceeds of collateral".

The Circuit Court, believing it unnecessary to elaborate further on this critically important subject, has merely stated: (See "A" of Appendix)

> "At the time petition in bankruptcy was filed, Piro had a substantial inventory of boys' clothing on hand but only a small portion of it constituted items sold by appellee on July 20, 1966. The rest had been bought by Piro subsequent to that date. . . . The question is whether a lien on after-

acquired inventory can qualify as a 'purchase money security interest' . . . Accordingly in our view the lien on inventory items subsequently acquired as replacement for the original items subject to lien is a 'purchase money security interest' under §9107."

But as a review of the record before the lower Court and a study of the relevant authorities will show:

A. *THE RESPONDENT HERE (APPELLEE) NOT HAVING EITHER ACTUALLY SOLD OR FINANCED THE SALE OF THE AFTER-ACQUIRED INVENTORY GOODS, COULD NOT IN ANY EVENT BE, OR BE TRANSFORMED, BY ANY LEGAL FICTION, INTO THE HOLDER OF A "PURCHASE MONEY SECURITY INTEREST" IN SUCH AFTER-ACQUIRED GOODS; and,*

B. *THE RESPONDENT NOT HAVING NOTIFIED UNSECURED CREDITORS BY THE FINANCING STATEMENT WHICH IT FILED WITH THE SECRETARY OF STATE THAT IT LAID EXPRESS AND SPECIFIC CLAIM TO THE PROCEEDS OF SUCH INVENTORY COULD NOT, AS A MATTER OF LAW, (AND BANKRUPTCY LAW PARTICULARLY) SUCCESSFULLY LAY CLAIM TO SUCH PROCEEDS.*

C. *AS HERE CONSTRUED AND AS HERE APPLIED SECTION 9102(4) OF THE CALIFORNIA COMMERCIAL CODE READ TOGETHER WITH SECTION 9108 OF THAT CODE IRRECONCILABLY COLLIDE WITH THE PARAMOUNT PROVISIONS OF SECTION 60 OF THE BANKRUPTCY ACT.*

Since the Supreme Court constitutionally exercises broad authority over the whole field of bankruptcy, and since earlier decisions of this Court like those of *Benedict v. Ratner,* 268 U.S. 353 and *Corn Exchange National Bank & Trust Co. v. Klauder,* 318 U.S. 434 (among others) are directly affected by the decision here insofar as "proceeds" are concerned, we therefore believe it appropriate that certiorari be granted to settle the critically important commercial and bankruptcy law problems, not heretofore resolved.

(b) The respective rights and priorities under the new Uniform Commercial Code, as between particular secured creditors (holders of security interests) and unsecured creditors (or their trustee in bankruptcy) have not authoritatively been defined by this Honorable Court, but should be. This case, with its undisputed, and sharply etched facts, presents an ideal opportunity, we submit, to decide critically important issues required by the business community in the setting of the newly adopted Uniform Commercial Code, but not yet decided by this Court.[2]

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[2]New terms have been introduced into the lexicon of the Commercial law by the draftsmen of the Uniform Code. Their newness causes confusion and uncertainty in meaning, which ought to be eliminated. What was once called a lien (or a chattel mortgage, or a conditional sales contract, or a trust receipt) are all now subsumed by the new term "security interest". What was once labelled the contract of mortgage (or of pledge, or of conditional sale) is now blanketed under the shorthand phrase, "security agreement". Instead of the plethora of recording devices and recordation formulae which had long existed in commercial practices, there is now substituted the unitary financing statement, filed generally with the Secretary of State, and thereby purportedly giving statewide notice to creditors of the nature of the security interest claimed by the secured creditor who files that "Financing Statement".

## II.

## The Respondent Not Having Either Sold or Financed the Sale of the After-Acquired Inventory Could Not in Any Event Be, or Be Transformed, by Any Legal Fiction, Into the Holder of a "Purchase Money Security Interest" in Such After-Acquired Goods.

(a) Only California appears to have adopted, as a part of its Commercial Code, a section 9201(4) containing this specific underscored clause:

> ". . . No nonpossessory security interest, *other than a purchase money security interest,* may be given or taken in or to the inventory of a retail merchant held for sale . . ." [Emphasis added.]

Apparently, not one of the 27 other states which have enacted the Uniform Commercial Code has similarly included this exclusionary phrase "other than a purchase money security interest".[3]

When Section 9102(4) became effective on January 1, 1965 California law expressly interdicted without exception liens of all kinds upon the inventory of retail merchants.[4]

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[3]In 1961 the Oregon Legislature enacted the Code with an amendment prohibiting the creation of security interests in after-acquired inventory. However, as its 1963 session the Oregon Legislature repealed this amendment. (16 Stanford L.R. 149).

[4]Under former Section 2955(3) of the California Civil Code, a chattel mortgage could not be made upon "the stock in trade of a merchant". While the Inventory Lien Law of California authorized *certain borrowers* to create "continuing liens" on their inventory (former section 3031 of the California Civil Code) nevertheless former section 3030(3) of the California Civil Code categorically provided that "borrower . . . shall not include a retail merchant . . ."

These statutes reflected the long-standing antipathy in California against roving liens upon the inventory of a retail merchant evidently because the rapid acquisition of newer and newer

This phrase "purchase money security interest" when parsed carefully means, of course, a "purchase money *encumbrance*" for the last two words of the phrase "*security interest*" are today's counterpart of the older and simpler word "encumbrance".

What is a purchase money encumbrance? Unfortunately, we submit, the opinions below have not carefully examined this question in the setting of the statute in which it is found. The code definition, insofar as here applicable, is set out in Section 9107(a) of the California Commercial Code.

> "9107. Definitions: 'Purchase Money Security Interest'. A security interest is a 'purchase money security interest' to the extent that it is (a) Taken or retained by the *seller* of the *collateral* to secure all or part of *its price*; or (b) Taken by a person who by *making advances* or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral *if such value is in fact so used*." [Emphasis added.]

Patently, part (a) of Section 9107 deals with one who has sold the collateral, and taken back a lien on that collateral to secure all or part of its purchase price; equally patently, part (b) of Section 9107 deals with one who has advanced the funds which enabled the debtor to acquire the collateral *if the funds advanced are in fact so used by the debtor.* The respondent here, if he falls at all into either part (a) or (b) of Section 9107, falls into part (a).[5]

---

nondurable goods, sold on credit by hosts of vendor creditors of that retailer, resulted in a hopelessly confused mass upon which no effective secured claim could exist as long as that asserted secured claim was nonpossessory.

[5]We shall attempt to show, *infra*, that the lower courts have erroneously, and by resort to an inapplicable legal fiction, placed respondent within the ambit of part (b) of 9107, in order to support their decisions.

We submit that this statutory definition means that in order for a security interest to be a *purchase money* security interest under part (a) it must in any and all events be taken back by the *seller* of the *collateral.* This is the *sine qua non* of a purchase money encumbrance in California because:

In California, when the Uniform Commercial Code was adopted in 1965, there was already wide experience with, and repeated judicial definition of, the precise meaning of the concept "purchase money encumbrance" or "purchase money mortgage."

These purchase money mortgages (now purchase money security interests) were well known in California in 1965 when Section 9107 first became a part of California's new Commercial Code. These purchase money mortgages had formed the core of a series of code sections (California Code of Civil Procedure Sections 580(a), (b), (c) and (d)) regulating the right of an unpaid seller of real property, on credit, to recover a personal deficiency judgment, against the defaulting buyer of that property. Section 580(b) expressly proscribed any personal deficiency judgment in case of default by a buyer, when the encumbrance taken back by the seller was a *purchase money encumbrance.*

And so, as unpaid vendors of real property sought personal deficiency judgments against their defaulting buyers, the latter countered that the seller was not entitled to a personal deficiency judgment because the obligation of the buyer was a "purchase money encumbrance".

Out of this conflict, there emerged a large body of case law stretching from *Mortgage Guarantee Co. v.*

*Sampsell*, 51 Cal. App. 2d 180 (1942) through *Sosna v. Baranov*, 240 Cal. App. 2d 460 (1966) by way of the California Supreme Court decision in *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35 (1963).[6]

The precise definition of the phrase "purchase money obligation" that is extractable from these authorities, is made crystalline by the last of these cases at page 464 of *Sosna* (240 Cal. App. 2d 460) where the court said:

> "The case of *Roseleaf Corp. v. Chierighino*, 59 Cal. 2d 35 holds that a trust deed securing a note executed by a vendee to the vendor for a part of the purchase price, which encumbers property *other than the property purchased is NOT* a purchase money deed of trust." [Emphasis added.]

The close affinity between the "purchase money encumbrance" of California Code of Civil Procedure Sections 580(b) etc. and the "purchase money security interest" of California Commercial Code Section 9107, is nowhere more clearly shown than in the editor's comment to the latter section found in the official text of West's Annotation to Section 9107 of the California Commercial Code:

> "Its [i.e. the "purchase money security interest"] counterpart under prior California law was the '*purchase money* mortgage' or security interest *purchase money* 'deed of trust'." [Emphasis added.]

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[6]Among other California cases dealing with this specific problem are the following: *Paramount Savings & Loan Assn. v. Barber*, 263 Cal. App. 2d 166, 169 (1968); *Investcal Realty Corp. v. Edgar H. Mueller Constr. Co., Inc.*, 247 Cal. App. 2d 190, 198 (1966); *Heckes v. Sapp*, 229 Cal. App. 2d 549, 552-53 (1964); *Orlando v. Berns*, 154 Cal. App. 2d 753, 758 (1957).

Consonant with the rule of statutory construction, certainly the meaning of the term "purchase money mortgage" in the anti-deficiency judgment statutes of California supplies a relevant guide to the meaning of the term "purchase money security interest" dealt with in Commercial Code Sections 9102(4) and 9107. (See *Braen v. Pfeifer Oil Transportation Co.*, 361 U.S. 129).

And it is, of course, reasonable to assume that the California legislature intended the basic definition of the term "purchase money obligation" to be the same in both statutes (*Select Base Materials, Inc. v. Board of Equalization*, 51 Cal. 2d 640, 645 (1959).)

And this reading of the term "purchase money security interest" comports with its older common law usage as set forth in *Williams v. American Slicing*, 98 S.E. 270.

> "Purchase money is the *original* debt or consideration which the purchaser agrees to pay for a thing in money."

and in *Henicler v. Wichum*, 38 Md. 270; *Eyster v. Hatheway*, 50 Ill. 52

> "The term 'Purchase money' is one used to designate the money stipulated to be paid by the purchaser *to the vendor for the goods sold to the purchaser*."

and in 50 Cal. Jur. 2d 141; *Sparks v. Hess*, 15 Cal. 186 (1860); *Baum v. Grigsby*, 21 Cal. 172 (1862);

> ". . . a vendor should be allowed to subject the property *with which he has parted*, to the satisfaction of *the debt* that constitutes the consideration for the transfer." [Emphasis added.]

Thus, to be a purchase money obligation, it must be an obligation given to the seller by the buyer, and it can only be given upon the property which was sold to the buyer to secure its price. All these elements must coalesce to carve out the purchase money obligation (security interest).

To so read section 9107(4) of the California Commercial Code is not to read that section narrowly; nor is it to read that section broadly; it is but to read it carefully. For the section itself says: "9107 Definitions. 'Purchase Money Security Interest' A security interest is a 'purchase money security interest' *to the extent that it is:* (a) Taken or retained by the *seller* of the *collateral* to secure all or part of its price." [Emphasis added] Now, of course, there may be security interests of all kinds. But "a purchase money security interest" only arises when it is taken by the seller of the collateral, upon that collateral in order to secure the payment of the price of that collateral.

In the case at bench, the respondent was *not* the seller of the after-acquired collateral upon which the lien was successfully asserted; and, the lien taken did *not* secure the price of that collateral. Respondent's security interest was taken by it on inventory sold in 1966 and long gone by 1970; the lower courts have here given respondent a security interest upon inventory which respondent never sold; and, have given him a lien on goods sold by third parties to secure an obligation which did *not* represent the *price* of these latter goods.

The lower courts relied upon the "after acquired property clause" of the agreement, and upon part (b) of Section 9107 to reach their result. But just as a stream cannot rise above its source, so this "after ac-

quired property" clause cannot rise above its own source; and, that source is the "purchase money security interest" clause of the statute. Otherwise, the tail would indeed wag the dog; for surely no lesser requirements could attend the "purchase money security interest" in the after-acquired inventory than attend the "purchase money security interest" in the original goods. No person, other than the real and actual vendor of the original goods could ever hold "a purchase money security interest" in the original goods, even though he might hold other security interests on other property. How then could any one other than the actual vendor of the after-acquired goods ever hold a purchase money security interest in those after acquired-goods, whatever other security he might otherwise hold?

As we see it, the purchase money security interest in after acquired property, as claimed in the security agreement here, means a security interest in after-acquired property which the borrower subsequently purchases from the vendor of the original goods; that is to say, if the respondent here had sold goods on credit to the bankrupt after the first 1966 transaction, then, and with respect to such post 1966 inventory sales to the bankrupt, and for which payment had not been made, the respondent would hold a purchase money security interest; and, he would hold that purchase money security interest without need to re-file a new financing statement for each subsequent sale to the bankrupt. If the respondent did not sell the subsequently acquired inventory to the retailer, Piro, the respondent's legal inability to claim a purchase money security interest therein was the same legal disability as would have applied to the original goods, if the respondent had not, in fact, been the vendor of the original goods.

The respondent here cannot be transformed by legal magic into the seller of inventory goods, if in fact he had not sold them. And he could not lawfully take back a lien upon goods a third party sold, in order to secure the purchase price of goods which the respondent never sold.

The question, as the statute envisions it, is one of fact, not fiction, legal or metaphysical.

The lower Court has sought to resolve this question by the following postulate involving the following assumptions and fictions:

> "If a purchase money security interest in retail inventory is to have any commercial usefulness, it must accommodate the resale of the inventory under lien. Resale of that inventory is the very reason for its purchase.
>
> This could be accomplished by an elaborate and cumbersome arrangement whereby the resale of any item subject to lien is permitted by the lienholder, the proceeds of such resale are impounded to apply upon the note, and the lienholder then consents to use of the impounded sums for purchase of replacement items of inventory, taking a new lien on such new purchases. The floating lien on after-acquired inventory items is but a shorthand version of this arrangement. By consenting to resale of the collateral and use of the proceeds of such resale to acquire replacement items, the seller (lender) has given value to enable the purchaser (borrower) to acquire the new collateral. In effect, he has renewed his advance by releasing the proceeds of resale.
>
> "Accordingly, in our view, the lien on inventory items subsequently acquired as replacement for

> the original items subject to lien is a 'purchase money security interest' under §9107.
>
> "This does not serve to read §9102(4) out of California's Commercial Code. Inventory liens remain strictly limited to that which was purchased, or the replacement of that which was purchased. General inventory liens or those for other than purchase obligations are still forbidden. The state requirement for giving notice of the financial arrangements serves to protect future sellers of inventory as well as general creditors."

But this judicial gloss ignores the heart of, and eliminates the core of the statutory definition in 9107(b) of a purchase money security interest in favor of a lender as one "Taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral *if such value is in fact so used.*" [Emphasis added.]

But neither the Circuit Court, nor the District Court, nor the Referee had before them even a scintilla of proof showing that, in fact, the bankrupt Piro had actually used any funds or credit advanced to him by the respondent in order to acquire additional or substituted collateral. Nor can there be any valid presumption, such as was employed below, that a retail merchant, in fact, always uses the proceeds of inventory sales, in order to replenish the same. Indeed he might, and he very often does, use such proceeds in order to pay his rent, to pay his employees, to discharge his taxes, etc. And he might and often does, use his own capital (or the proceeds of a public stock issue) to acquire fresh inventory. What we are saying is this:

the legislature has made it a question of actual fact, in order for a lender to acquire a purchase money security interest in inventory (original or after acquired), that the lender show that the debtor, in truth and in fact, actually used the lender's funds to acquire the inventory upon which the lien is claimed by that lender. The legislature has expressly done this by categorically limiting a lender's purchase money security interest to those cases in which the lender can show that his debtor, in fact, *actually used the loan proceeds* to purchase the particular goods upon which the lender's claimed lien attaches.

Part (b) of Section 9107 is not a vaguely expanding phrase. It is a categorically restricting one; for it is restricted to those instances wherein lender's advances are shown in fact to have been used by the borrowing merchant to acquire specific inventory upon which a lien is then given.

This is a far cry, however, from the Court's determination that as against a trustee in bankruptcy (the idealized creditor holding an unsatisfied judgment lien against all the debtor's assets, including his after-acquired inventory) there is a conclusive presumption that because of the "after acquired property" clause, Mr. Piro *must in fact* have used the *proceeds* of the sale of the original inventory in order to acquire *additional inventory*. The assumed postulates relied on by the lower courts to reach their conclusion are expressly made impermissible by the history of, and by the express language of part (b) of Section 9107 which, as already indicated reads "A security interest is a 'purchase money security interest' to the extent that it is (a) . . . or (b) Taken by a person who by making advances or incurring an obligation gives value to en-

able the debtor to acquire rights in or to the use of collateral if *such value is in fact so used.*" [Emphasis added]. That critically important fact is simply not supplied by the Court's underlying assumption that "by *consenting* to resale of the collateral and use of the proceeds of such resale to acquire replacement items, the seller (lender) has given value to enable the purchaser (borrower) to acquire the new collateral. In effect he has renewed his advance by releasing the proceeds of sale."[7]

III.

**The Respondent Secured Party Not Having Notified Unsecured Creditors by the Financing Statement Which It Filed With the Secretary of State That It Laid Express and Specific Claim to the Proceeds of Such Inventory Could Not as a Matter of Law (and Bankruptcy Law Particularly) Successfully Lay Claim to Such Proceeds.**

We turn to the question whether, and in any event, the particular secured creditor here, may legally lay claim to the *proceeds* realized from the sale of inventory goods sold to the bankrupt by others than the secured creditor himself.

We are told on all sides that the most novel feature of the Uniform Commercial Code respecting secured transactions, is its substitution of a unitary security device, the filed financing statement, for the great many personal property security devices otherwise in use during the pre-commercial code years. (42 Oregon Law Review 1; 8 U.C.L.A. Law Review 806.)

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[7]We shall attempt to show (immediately hereinafter) that, as a matter of fact, in the case at bench, there was no consent by this secured creditor to the use of the proceeds of resale to acquire replacement items.

Except only for this filed financing statement, there are today no other recording or notice requirements in the commercial law field. Insofar as public records are concerned, only and solely by inspection of the filed financing statement can an existing or potential creditor have the opportunity to inform himself of whether, and of the extent to which, an existing or prospective debtor has encumbered his assets, and to govern himself accordingly in dealing with that debtor. (Com. Code §9407; *In re Thomas* (9 Cir.) 366 F.2d 51; *Lines v. Bank of California* (9 Cir.) 467 F.2d 1274.)

In the case at bench, such a creditor inspecting this particular financing statement in 1969 or early 1970, would have learned that the financing statement covered the following types or items of property: "Inventory of boys' clothing now and hereafter contained in the premises at 7644 Girard Street, La Jolla, California", and the prospective creditor would have learned that the secured party did *not* specifically claim that the *proceeds* of the then or thereafter acquired inventory were covered by the Security Agreement. And he would *not* have learned from inspecting the financing statement itself that it granted the appellee a *purchase money security interest* in the proceeds of the inventory then or thereafter contained at the bankrupt's premises.

The question of the sufficiency of a filed financing statement has been before the Ninth Circuit Court in the recent cases of *In re Thomas* and *Lines v. Bank of California, supra.* In *Lines,* that Circuit held the failure of the financing statement to list the residence address of the debtor was inconsequential, so long as his business address was shown thereon. In *Thomas*

the Court held the failure of the financing statement to show the debtor's real name, was fatal, even though the fictitious business firm name was disclosed, and even though creditors assertedly knew the debtor by that fictitious business firm name.

There is no dispute that the financing statement, as filed, does not contain a claim to the proceeds of the collateral.

Here the failure on the face of the financing statement to affirmatively assert that the *proceeds* of the collateral were claimed, is surely not inconsequential. A creditor ought, with certainty, to know whether or not a secured creditor claims the proceeds of the specified collateral. Here the Court below has held that the general creditor must be deemed to know that the *proceeds* of an inventory lien are *always* claimed by the secured party whenever he asserts a lien upon inventory. This conclusion was reached by the Ninth Circuit by advancing the following thesis:

> "If a purchase money security interest in retail inventory is to have any commercial usefulness, it *must* accommodate the resale of the inventory under lien. Resale of that inventory is the very reason for its purchase." [Appendix A; emphasis added.]

But this theory, while glittering, is scarcely golden; for there are many instances where a lien upon inventory items would *per se* be valuable, even though a lien upon *proceeds* of an inventory lien might be even more valuable.

Preliminarily, we observe that there are indeed many liens upon inventory items of a retail merchant which are in and of themselves valuable, with or without a

claim to the proceeds of the sale of such items. Thus, retail jewelry merchants sell diamonds; retail furriers sell fur pieces; retail art merchants sell Picassos and Renoir paintings; retail druggists sell drugs of high cost and intrinsic value. A lien upon such inventories has commercial usefulness despite the lower court's sweeping assertion to the contrary.

The real question is not whether a secured creditor would be better protected if he could successfully assert a claim to proceeds, but whether, as a matter of law, he has properly perfected his security claim to such proceeds. The proper answer to this question is to be found, not in a glittering generalization, but in a consideration of the relevant authorities which encase the answer.

First off, if a purchase money security interest in inventory items *always* and *per se* covered the *proceeds* of the sale of such inventory items, as well as the proceeds of the sale of after acquired inventory items, then there would be no reason for the elaborate provisions of Section 9306 of the Commercial Code, which define very carefully when *proceeds* are a part of the collateral itself, and when *they are not* (*cf.* subsections (1) and (2)); and, define equally carefully when no right to proceeds of collateral exists in favor of the holder of the collateral itself (9306(3)); and, surely, if the proceeds of the item always followed the item, then most assuredly there would be no reason for the statutory provision which details the instances when the rights to such proceeds are lost.

One need only glance at the following portions of California Commercial Code Section 9306 to realize that the proceeds of collateral are not necessarily an

inseparable adjunct of collateral; that the one does not subsume the other, for we find in that code section the following: "9306 ["Proceeds"; Secured Party's Rights on Disposition of Collateral]:

* * *

"(3) The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected, but it ceases to be a perfected security interest and becomes unperfected 10 days after receipt of the proceeds by the debtor unless

(a) A filed financing statement covering the original collateral also covers proceeds; or

(b) The security interest in the proceeds is perfected before the expiration of the 10 day period.

(4) In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest.

(a) In identifiable noncash proceeds and in a separate bank account containing only proceeds;

(b) In identifiable cash proceeds in the form of money which is not commingled with other money or deposited in a bank account prior to the insolvency proceedings;

(c) In identifiable cash proceeds in the form of checks and the like which are not deposited in a bank account prior to the insolvency proceedings; and,

(d) In all cash and bank accounts of the debtor in which proceeds have been commingled

with other funds, but the perfected security interest under this paragraph (d) is

(i) Subject to any right of setoff;

and

(ii) Limited to an amount not greater than the amount of any cash proceeds received by the debtor within 10 days before the institution of the insolvency proceedings less the sum of (I) the payments to the secured party on account of cash proceeds received by the debtor during such period and (II) the cash proceeds received by the debtor during such period to which the secured party is entitled under paragraphs (a) through (c) of this subdivision (4)."

Nor is appellee's right, *per se*, to the proceeds of the collateral any stronger because the security agreement by its terms grants appellee a security interest in the *accessions* to the original inventory [TR 15]. The elaborate provisions in Section 9314 deal with a security interest in such accessions to goods; there in subsection (3) the legislature has provided that such a security interest in accessions to goods, *does not take priority over*

"(b) A creditor with a lien on the whole subsequently obtained by judicial proceedings. . . ."

And, of course, the Trustee in bankruptcy is that idealized hypothetical lien claimant as at the date of bankruptcy. (11 U.S.C. §110 (c); *Sequoia v. Jarret*, (9 Cir.) 410 F.2d 1116, 1119; *In re Thomas, supra.*

Interesting in this regard is subsection (4) of Section 9204:

> "(4) No security interest attaches under an after acquired property clause (b) To consumer goods other than accessions (Section 9314) or replacements when given as additional security unless the debtor acquires rights in them *within 10 days* after the secured party gives value." [Emphasis supplied.]

Surely we would reach a bizarre result here if the "after acquired" property clause of the particular security agreement made at the time of the original inventory sale in 1966, somehow attached automatically to the *proceeds* of the consumer goods (boys' clothing) sold to this bankrupt by other vendors during the years 1967, 1968, 1969, 1970.

And that a secured claim to collateral *does not per se carry with it a claim to the proceeds of that collateral,* is made crystal clear in the study entitled "California Chattel Security and Article Nine of the Commercial Code." (8 U.C.L.A. Law Review 806, at p. 878) where we are taught that:

> *"No such perfected security interest will automatically arise as to proceeds under the code unless the filed financing statement covering the original collateral also stipulated proceeds."* [Emphasis added.]

As indicated, it is the filed financing statement which imparts notice to creditors of the particular security interest given upon his assets by the debtor to a secured party. It is the one and the only notice given to creditors of the liens created by their debtor. Only because of this notice is the high barrier erected by Mr. Justice Brandeis in *Benedict v. Ratner,* 268 U.S.

353, and by Mr. Justice Jackson in *Corn Exchange National Bank & Trust Co. v. Klauder*, 318 U.S. 434, ever scaled.

Since the financing statement here filed made no claim that the proceeds of the collateral was covered, it would be appropriate to find out more specifically what an inquiring creditor would have learned about the actual agreement between this particular secured creditor and this particular debtor concerning the precise nature of the security given by the latter to the former.

Such a potential creditor, exercising utmost care in the face of the uncertainty in the financing statement, would then have turned to the actual written security agreement between these parties. (That security agreement was before the Courts below; it is found as Ex. B at pp. 15-20 of the Record on Appeal. For ease of reference by this Court, that security agreement is marked F of the Appendix.). But that security agreement, the now bankrupt Mr. Piro agreed with the secured party as follows:

> "Debtor hereby warrants and covenants
>
> * * *
>
> 5. *That Debtor will not sell or offer to sell or otherwise transfer the collateral* or any interest therein without the written consent of Secured Party. . . ." [Emphasis added.] [No such consent is here shown.]

And that security agreement further provides:

> "Until default Debtor may have possession of the collateral and use it in any lawful manner not inconsistent with this agreement, and not inconsistent with any policy of insurance." [TR 17-18].

And it is there expressly declared to be an act of default by the debtor, if the debtor sells the collateral. Thus, the Security Agreement provides:

> "Debtor shall be in default under this Agreement upon the happening of any of the following events or conditions: . . . (d) Loss, theft, destruction, *sale* or encumbrance to or of any of the collateral . . ." [Emphasis added.]

With such a Security Agreement prohibiting sales of the collateral in the first instance, and declaring it to be an event of default if there were in fact such sales, it cannot, we submit, be said that the financing statement as filed must be construed, *per se*, as the courts below have done, to cover proceeds of the sale of after-acquired inventory. This certainly must be true when, as here, the filed financing statement makes no such claim to proceeds.

Finally, we submit, *arguendo*, that even if it be assumed that the parties could have executed a purchase money security agreement expressly covering the proceeds of sales of goods sold by third parties to the retailer; and, could have filed a financing statement expressly covering the proceeds of such after-acquired goods, that even this assumption would not support the judgment below.

This is so because the rights of the parties where bankruptcy intervenes is determined by what they did actually do, and not by what they could have done. And the short answer here is: *They Did Not Do So.* What was said in *DuBay v. Williams*, 417 F.2d 1277, 1288 about a like situation where the agreement, as drawn by the parties, failed to meet the applicable legal standards, is here apposite: "*They (i.e.* the parties)

*could have done so, but they did not, and we cannot draw for them an agreement they did not draw for themselves.*" That rule must surely apply here for the security agreement is carefully drawn so as not to cover *proceeds* in order to avoid any inference that the secured party was agreeing in advance to the disposition of his collateral.

Most assuredly, if this single simple unified filed financing statement is to serve as notice to the world of the particular liens given by a debtor to his creditors (as claimed by the sponsors of the Uniform Commercial Code), then that filed statement ought *clearly* to disclose to creditors that the *proceeds* of collateral are being liened. Silence in that regard is secretive. And secret liens are, of course, void as against the Trustee.

IV.

**As Here Construed and as Here Applied Section 9102 (4) of the California Commercial Code Read Together With Section 9108 of That Code Irreconcilably Collide With the Paramount Provisions of Section 60 of the Bankruptcy Act.**

The pervasive objective of the Bankruptcy Act is equality. To achieve that end, the voidable preference provisions of Section 60 of the Act and the "strong arm" provision of Section 70 have been fashioned and refashioned down through the years (16 Law and Contemporary Problems 76 (Countryman); 108 University of Penn. Law Review 194 (Friedman)).

There can be no doubt of the paramountcy of these Bankruptcy Act provisions over conflicting State statutes or decisions. By section 60 of the Act (11 U.S.C. 96 (1958)) certain transfers (including secured fi-

nancing agreements) are voidable as preferences as against the trustee, even though there has been strict compliance with the State law governing security perfection, if in fact the transfer is made in full or partial satisfaction of an antecedent debt and the other elements of a preference exist. (McLachan, Preference Redefined, 63 Harvard L.R. 1390)

The specific question here is whether the attempted transfer in 1970 of the proceeds of the after acquired inventory to apply on the debt created in 1966, was, or was not, in full or partial satisfaction of an antecedent debt, or was it actually for a new consideration.

But as the lower Courts here have dealt with this problem, the question is conclusively to be resolved by resort to a series of fictions; viz., first the fiction that the holder of a lien upon inventory must always have consented to the sale of that inventory by his debtor, whether that be the fact or not; second, the fiction that the debtor when he sells an inventory item must always be deemed to have used the proceeds of that sale solely and exclusively to acquire a new inventory item; third, the fiction that this newly acquired inventory item actually replaces a prior inventory item sold in the interim and automatically replaces it.

That these hypotheses are all too often contrary to fact in the real world seems self-evident. And, therefore, one need not possess the power of divination to know that the draftsmen of Section 1-9108 of the Uniform Commercial Code (adopted by California in 1963 in toto as Section 9108 of the California Commercial Code) evoked that language in a precise effort to avoid the effect of Section 60 of the Bank-

ruptcy Act. (See Friedman, The Bankruptcy Preference Challenge, 108 U. Penn. L.R. 194, 215.)

Indeed, the whole story is boldly told in the printed comments to that same Section 9108 which are set out in the Commercial Code itself. There we are told:

"CALIFORNIA CODE COMMENT

"By John A. Bohn and Charles J. Williams Prior California Law

"1. The operation and effect of this section are described in the Marsh and Warren Report:

'This Section is intended to operate only in bankruptcy and to provide that property acquired by a debtor and becoming security for an antecedent debt pursuant to an afteracquired property clause in the original loan agreement shall be "deemed" *not* to be for an antecedent debt and, therefore, not a recoverable preference in bankruptcy, even though it is acquired within four months of bankruptcy and while the debtor is insolvent to the knowledge of the secured party. In our opinion, this is an attempt to amend Section 60 of the Bankruptcy Act, which is clearly beyond the power of California or any other State. The Official Comments state that what is an "antecedent debt" under Section 60 of the Bankruptcy Act is a matter of State law. No authority is cited for this proposition and, in our opinion, it is erroneous. So far from leaving the definition of this term to State law, Congress has provided 8 subdivisions to Section 60a, containing pages of practically incomprehensible verbiage, explaining what is meant by antecedent debt

(or, what amounts to the same thing, when a transfer shall be considered to have occurred) and when some transfers shall be "deemed" not to be for an antecedent debt by virtue of a limited relation back. The situation covered by Section 19108 is not among the latter. It is obvious as a matter of fact, rather than fiction, that in this situation the debt is incurred first, the security interest is transferred at a later time (since the property *cannot* have been transferred before it was acquired by the debtor), and therefore it is a transfer for an antecedent debt. See Comment, (*The Commercial Code and Bankruptcy Act: Potential Conflicts,* 53 N.W. U.L.REV. (1958) 411, 412-418.)

"Without going into the merits of the proposed rule of this Section, it is a matter which, in our opinion, should properly be left to Congress where it belongs. The retention of this Section will only lead to extensive and probably useless litigation.' Sixth Progress Report to the Legislature by Senate Fact Finding Committee on Judiciary (1959-1961) Part 1, The Uniform Commercial Code, p. 556."

While, as appears from the same printed text, the California State Bar Committee disagreed and prevailed before the Legislature. We think it clear that the quoted argument presents the case as it is, and not as it is idealized by draftsmen of the Statute.

But the best word, we think, on this problem is stated by Professor Marsh; reference thereto is also quoted in full in the printed comments to Code Sec-

tion 9108 itself: (West's Annotated California Commercial Code, Section 9108, p. 366):

> "In response to these State Bar Comments Professor Marsh maintained the earlier position of the Marsh and Warren Report:
>
> 'It seems to me that the discussions of this section proceed under a misapprehension. No one questions the fact that the "validity" of a chattel mortgage and an after-acquired property clause in a chattel mortgage (or other security device) is governed in bankruptcy by State law. The question is whether the time when an otherwise valid transfer is "deemed" to have occurred, for the purpose of testing whether it is a voidable preference, is determined by state law. Therefore, the cases cited are beside the point. Section 60 of the Bankruptcy Act is an explicit refutation of any affirmative answer to the real question (except to the extent expressly provided therein). See *Curtis v. Knox*, 254 F. 2d 433 (7th Cir. 1958).
>
> 'A chattel mortgage given one month prior to bankruptcy while the mortgagor is insolvent to secure a debt incurred six months prior to bankruptcy is "valid" under State law, but is nevertheless a recoverable preference in bankruptcy if the other requirements of Section 60 are met. Could a State enact a law saying in this situation that the chattel mortgage shall be "deemed" to have been given at the time the debt was incurred, thereby making it not for an antecedent debt and not a recoverable preference? It is inconceivable to me, and I think it would be to any bankruptcy lawyer, that the Supreme Court would uphold

> such a statute. Yet there is no difference in theory between such a statute and Section 19108 [9108]. If "state law" determines when a transfer is "deemed" to have been made, then a state could destroy the effectiveness of Section 60. And of course Section 19108 would apply to no independent state question—it does not have "particular significance" in bankruptcy; it has significance only in bankruptcy. No state law question turns upon whether a transfer is for an "antecedent debt" or not. Therefore, such cases as *Aquilino* and *Bess*, aside from the fact that they deal with entirely different subjects, have no relevance here.' Sixth Progress Report to the Legislature by Senate Fact Finding Committee on Judiciary (1959-1961) Part 1, The Uniform Commercial Code, p. 642."

The logic of this position is irrefutable. If, in fact, the after acquired inventory item actually replaces a prior inventory item there has been no depletion of the debtor's estate and no unsecured creditor is injured; this is true or false, as the facts may show. But this is never *always* and *conclusively* true, as the lower courts have here ruled. If, in fact, the debtor actually employs the *proceeds* of the sale of an old inventory item to purchase a new inventory item, there has been no depletion of the debtor's estate, and no unsecured creditor has been injured; this is true or false, as the facts may show. But this is never always and conclusively true. Such a conclusive presumption as that created here by the lower courts is arbitrary, unreasonable, without foundation in fact and violative of the Fifth Amendment. See, *e.g., Western & Atlantic R.R. v. Henderson*, 279 U.S. 639.

Would it not be strange if all of the paramountcy of Congress in the field of Bankruptcy could be effectively nullified by a State legislature's adoption of a series of statutes or presumptions defining four months to conclusively mean four months and ten or twenty or thirty additional days?

Nor did the draftsmen of the definition of "purchase money security interest" in Section 9107 adopt any such conclusive presumption as the lower Courts did; instead they let the question remain what it is—a question of fact, not presumption, for in (b) of their definition, they say: "If such value is *in fact* so used."

Our conclusion that the construction and application of the "after acquired property clause" as made by the lower courts in this case, as well as the text of Section 9108, irreconcilably clash with Section 60 of the Bankruptcy Act, is not reached without consideration of the two early decisions of the United States Supreme Court of *Thompson v. Fairbanks,* 196 U.S. 516 (1905) and *Humphrey v. Tatman,* 198 U.S. 91 (1905). These cases do hold that a lien upon after acquired property may be upheld, as against a trustee in bankruptcy, even though the underlying agreement is made more than four months prior to bankruptcy and possession is taken by the secured creditor of the after-acquired property on the eve of bankruptcy. This result was reached by this Court in both cases through the application of the doctrine of relation back, *e.g.,* that the lien attached to the after-acquired property when it came into existence and then related back to the earlier time when the mortgage was first recorded. But both these cases were decided long before the 1938 and 1950 amendments to Section 60; and these

amendments were clearly adopted in order to obviate the sweep of these two cases.

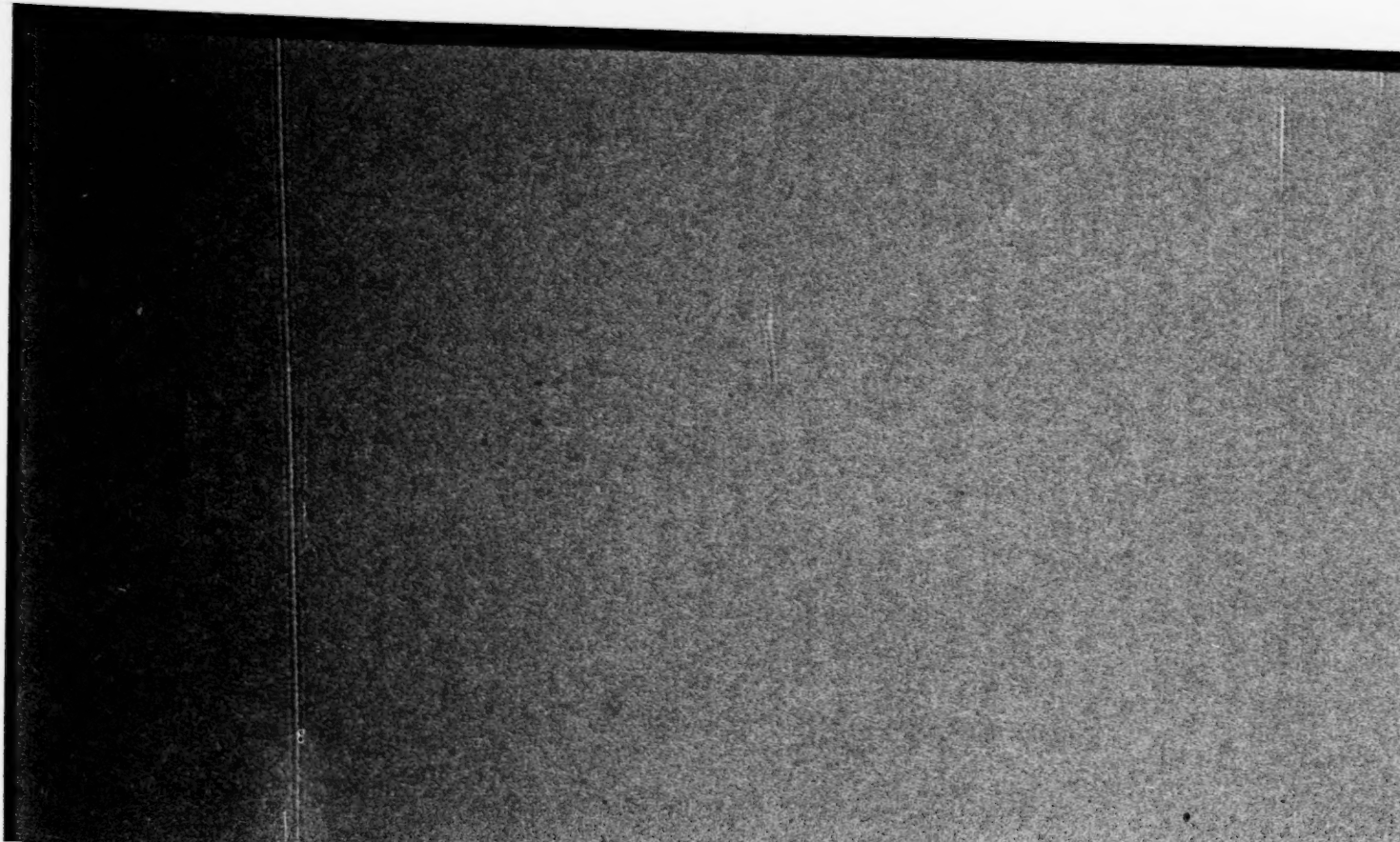
But the lower Courts, we submit, have misread and misconstrued sections 9102(4) as to what is in fact a purchase money security interest, have then utilized the fiction that a security interest in the *proceeds* is always conclusively presumed to exist even if the parties themselves have not so agreed; and have then finally construed Section 9108 so as to bring it into irreconcilable conflict with Section 60 of the Bankruptcy Act. Such a result ought not to be allowed to stand without review by this Court.

For all of these reasons, we pray the issuance of a writ of certiorari to the United States Court of Appeals for the Ninth Circuit.

CHARLES J. KATZ,
*Attorney for Petitioner.*

KATZ, HOYT & BELL,

LUCE, FORWARD, HAMILTON &
SCRIPPS,
*Of Counsel.*



## APPENDIX A.

### Opinion of the United States Court of Appeals for the Ninth Circuit.

In the United States Court of Appeals for the Ninth Circuit.

Lawrence Holzman, Appellant, vs. L. H. J. Enterprises, Inc., Appellee. No. 72-1208.

Filed April 5, 1973.

On Appeal from the United States District Court for the Southern District of California.

Before: Merrill and Kilkenny, Circuit Judges, and Taylor, District Judge.*

MERRILL, Circuit Judge:

In this appeal from order of a referee in bankruptcy, affirmed by the District Court, the issue is whether a nonpossessory security interest can, under California law, be taken as to after-acquired items of inventory of a retail merchant.

Appellant is trustee in bankruptcy for Pasqual Patrick Piro, Jr. On July 20, 1966, appellee sold to Piro, doing business as Boys Towne, an inventory of boys' clothing, receiving in payment a promissory note in the sum of $18,584.55, secured by an agreement giving appellee a security interest "in all of the inventory of boys' clothing * * * and any and all additions, accessions and substitutes thereto or therefor." The security agreement was duly filed and recorded pursuant to state law. At the time petition in bankruptcy was filed, Piro had a substantial inventory of boys' clothing on hand

*Honorable Fred M. Taylor, United States District Judge for the District of Idaho, sitting by designation.

but only a small portion of it constituted items sold by appellee on July 20, 1966. The rest had been bought by Piro subsequent to that date. The inventory on hand was sold by appellant, as trustee, with appellee's lien attaching to the proceeds. It was stipulated that $500 of that sum represented that portion of the inventory actually bought July 20, 1966. Appellee claimed that the entire proceeds were subject to his lien.

Section 9102(4), California Commercial Code, reads:

> "Notwithstanding anything to the contrary, in this division, no nonpossessory security interest, other than a purchase money security interest, may be given or taken in or to the inventory of a retail merchant held for sale, except in or to inventory consisting of durable goods having a unit retail value of at least five hundred dollars ($500) or motor vehicles, house trailers, semitrailers, farm and construction machinery and repair parts thereof, or aircraft."

The question is whether a lien on after-acquired inventory can qualify as a "purchase money security interest." Section 9107, California Commercial Code, defines the term:

> "A security interest is a 'purchase money security interest' to the extent that it is
>
> (a) Taken or retained by the seller of the collateral to secure all or part of its price; or
>
> (b) Taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used."

The referee and the District Court ruled that under these statutory provisions appellee's lien extended to after-acquired inventory and accordingly that the entire proceeds of sale were subject to it. We affirm.

Section 9102(4) is a California departure from the Uniform Commercial Code, which was insisted upon by the state legislature. Appellant contends that this demonstrates legislative intent that pre-Commercial Code restrictions upon inventory liens should continue to apply and that nonpossessory security interests should be restricted to those which had then been recognized: chattel mortgages, conditional sales and trust receipts. As to inventory liens, law prior to the Commercial Code had expressly denied them to retail merchants. We cannot accept this construction.

If a purchase money security interest in retail inventory is to have any commercial usefulness, it must accommodate the resale of the inventory under lien. Resale of that inventory is the very reason for its purchase.

This could be accomplished by an elaborate and cumbersome arrangement whereby the resale of any item subject to lien is permitted by the lienholder, the proceeds of such resale are impounded to apply upon the note, and the lienholder then consents to use of the impounded sums for purchase of replacement items of inventory, taking a new lien on such new purchases. The floating lien on after-acquired inventory items is but a shorthand version of this arrangement. By consenting to resale of the collateral and use of the proceeds of such resale to acquire replacement items, the seller (lender) has given value to enable the purchaser (borrower) to acquire the new collateral. In effect, he

has renewed his advance by releasing the proceeds of resale.

Accordingly in our view the lien on inventory items subsequently acquired as replacement for the original items subject to lien is a "purchase money security interest" under §9107.

This does not serve to read §9102(4) out of California's Commercial Code. Inventory liens remain strictly limited to that which was purchased, or the replacement of that which was purchased, General inventory liens or those for other than purchase obligations are still forbidden. The state requirement for giving notice of the financial arrangements serves to protect future sellers of inventory as well as general creditors.

California courts have not ruled on the issue here presented. Cases on which appellant relies deal with law prior to the Commercial Code or with instances in which notice of the financial arrangement had not properly been given. One court has, however, discussed the question in dicta which support our conclusion. *Needle v. Lasco Industries*, 10 Cal.App.3d 1105, 1107, 89 Cal.Rptr. 593, 594 (Ct.App. 2d Dist. 1970).

Judgment affirmed.

## APPENDIX B.

### Memorandum Opinion.

United States District Court, Southern District of California.

In the Matter of Pasqual Patrick Piro, Sr., aka Pat Piro, individually and dba Boys Towne, Bankrupt. Bankruptcy No. 8368-K-S.

Filed: September 24, 1971.

This is a petition directed to the Court for review of the referee's decision adjudging that respondent was a secured creditor of the bankrupt and that respondent's lien attached to the proceeds of the sale at public auction of the inventory of the bankrupt.

Briefly stated, the facts are as follows. On July 22, 1966, by a written agreement, L. H. J. ENTERPRISES, INC. (hereinafter respondent) sold to the bankrupt all of the inventory of clothing and fixtures of a business known as Johnson's Ltd. located at 7644 Girard Avenue, La Jolla, California. Pursuant to the agreement, the bankrupt executed a promissory note in the sum of $18,585.55. The bankrupt also executed a security agreement in favor of respondent in and to all of the inventory of boys clothing and designated fixtures, and "any and all additions, accessions and substitutions thereto or therefor". The agreement stated that the respondent's interest therein was a purchase money security interest.

The parties to the agreement executed and duly recorded a financing statement which provided that it covered "inventory of boys clothing now and hereafter contained in the premises at 7644 Girard Street, La Jolla, California."

On March 10, 1970, the bankrupt filed a voluntary petition in bankruptcy. By that time, the bankrupt had defaulted on the promissory note, and the sum of $5,-143.92 with interest from October 21, 1969 was due and owing to the respondent.

The referee held that the respondent's lien was valid and attached to the proceeds of a sale, at public auction, of the fixtures and equipment and the inventory of clothing held by the receiver on April 7, 1970. The lien attached to the proceeds to the sum of $4,-143.92 plus interest. Subsequently, the trustee filed a petition for review of the referee's order.

In reviewing the actions of a Referee in Bankruptcy, Rule 52(a) Fed.R.Civ.P. and General Order in Bankruptcy 47, 28 U.S.C.A., direct that the District Court shall accept findings of fact unless clearly erroneous. This standard does not apply to legal conclusions. *Minnick v. Lafayette Loan & Trust Co.*, 392 F.2d 973 (7th Cir., 1968). The referee's conclusions of law, while entitled to respect, cannot be approved without the District Court's independent determination of the law. *In re Newcomb Interests, Inc.*, 171 F.Supp. 704 (N.D. Calif., S.D., 1959), 5 Moore, Federal Practice, ¶53.12 (5) at 3021 (2d ed., 1969), 2 Collier, Bankruptcy, §39.28 at 1519 (14th ed., 1971).

The trustee has argued that the respondent's lien is invalid under the prohibition, peculiar to California, against security interests in certain types of inventory of retail merchants. The relevant section is §9102(4) of the California Commercial Code.

> §9102(4) Notwithstanding anything to the contrary in this division, no nonpossessory security interest, *other than a purchase money security in-*

> *terest,* may be given or taken in or to the inventory of a retail merchant held for sale, except in or to inventory consisting of durable goods having a unit retail value of at least five hundred dollars ($500.00) or motor vehicles, house trailers, semi-trailers, farm and construction machinery and repair parts thereof, or aircraft. [emphasis added]

The threshold question is: Can the exception for purchase money security interests extend to after acquired property? This is a question of first impression, and therefore, §9102(4) must be interpreted in light of legislative intention, prior California law, and the overall policy of the California Commercial Code.

Section 9107 provides a definition of "purchase money security interest."

> §9107 A security interest is a "purchase money security interest" to the extent that it is (a) Taken or retained by the seller of the collateral to secure all or part of its price; or (b) Taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

The trustee has argued that §9107 should be given a very "definite and limited meaning" but the California Code Comment to §9107 indicates that the scope of the §9107 purchase money security interest overlaps the former devices of the conditional sale, chattel mortgage, trust receipt and inventory lien. California Commercial Code Annotated at 362 (West, 1964). Furthermore, §1102(1) directs that the Commercial Code be liberally construed.

A major innovation of the Uniform Commercial Code as adopted in California is that the floating lien is no longer disfavored. See §§9204, 9108 and 9205. The Uniform Commercial Code Comment to §9204 discusses the prejudice against the floating lien:

> The widespread nineteenth century prejudice against the floating charge was based on a feeling, often inarticulate in the opinions, that a commercial borrower should not be allowed to encumber all his assets present and future, and that for the protection not only of the borrower but of his other creditors a cushion of free assets should be preserved. That inarticulate premise has much to recommend it. This Article decisively rejects it not on the ground that it was wrong in policy but on the ground that it has not been effective. In the past fifty years there has been a multiplication of security devices designed to avoid the policy; field warehousing, trust receipts, "factor's lien" acts and so on. California Commercial Code Annotated, pp. 407-08 (West, 1964).

Any consideration of the meaning of the "purchase money" exception to the prohibition of §9102(4) must be taken in light of the Code's rejection of the prejudice against the floating lien. The parties responsible for the drafting of §9102(4) did not expressly limit the "purchase money" exception to the specific items of collateral sold to the debtor by the creditor, nor did they prohibit the use of the after acquired property clause in conjunction with purchase money security interests in inventory. The overall code preference for pur-

chase money security interests, and rejection of the prejudice against floating liens, operate to place the burden on the trustee to demonstrate that the legislative intent was to place a strict limitation on the "purchase money" exception to the prohibition of §9102 (4).

It is clear that the intention behind the peculiar California limitation on security interests in inventory of retail merchants was to preserve pre-Commercial Code California law. The "old" law did not prohibit the creation of all security interests in retail inventory. It appears, although there is no clear authority, that under the pre-Commercial Code law the chattel mortgage or the conditional sale device could be used to set up purchase money security interests in inventory. *See,* Summers, *Security Interests in a Retail Merchant's Inventory: California Amends the Uniform Commercial Code,* 16 Stan.L.Rev. 149, 150. Furthermore, chattel mortgages accompanied by after acquired property clauses were recognized prior to the adoption of the U.C.C. in California. *Bank of California v. McCoy,* 23 Cal.App.2d 192, 72 P.2d 923 (1937).

Under pre-Commercial Code law in California, it was possible for a clever seller to tie up the inventory of a retail merchant, both present and "after acquired", by a series of security interests in the goods and the proceeds of the goods. New purchase money loans of the proceeds would continue sellers' security interest, resulting in a floating lien. Because a continuing interest in inventory of a retail merchant could be achieved

under the complexities of the pre-Commercial Code law, it does not seem likely that the draftsmen intended to limit the "purchase money" exception to §9102(4) without explicit language to that effect. And if the exception were limited, as the trustee argues, the purchase money security interest in inventory would be commercially meaningless because of the rapid turnover in inventory normally experienced by retail merchants dealing in goods with a unit value less than $500.00.

The underlying purposes and policies of the Commercial Code are set forth in §1102(2):

> (a) To simplify, clarify and modernize the law governing commercial transactions;
>
> (b) To permit the continued expansion of commercial practices through custom, usage and agreement of the parties;
>
> (c) To make uniform the law among the various jurisdictions.

The strict interpretation of "purchase money security interest" urged by the trustee runs counter to the rules of construction and the purposes and policies of §1102.

A further possible argument against the recognition of respondent's security interest in the "after acquired" inventory of the bankrupt is that subsequent creditors may be misled or in some way harmed by recognition of after acquired property liens. But if this argument had any weight, then all floating liens would be susceptible to it. Most importantly, the Commercial Code depends on the concept of constructive notice through the recording procedures. The respondent duly

executed, filed and recorded the security agreement. Subsequent creditors were put on notice of respondent's claims against the inventory of the bankrupt.

It is concluded that the referee correctly determined that respondent's lien is a valid purchase money security interest in inventory and attaches to the proceeds from the sale of the inventory of the bankrupt. The order of the referee is affirmed.

DATED: September 24, 1971.

/s/ Edward J. Schwartz
EDWARD J. SCHWARTZ, Chief Judge
United States District Court

Copies to: Theodore W. Graham, Esq., Herbert Katz, Esq., Leland Featherman, Esq.

## APPENDIX C.

### On Petition for Rehearing.

In the United States Court of Appeals for the Ninth Circuit.

Lawrence Holzman, Appellant, vs. L. H. J. Enterprises, Inc., Appellee. No. 72-1208.

Filed: June 15, 1973.

Before: Merrill and Kilkenny, Circuit Judges, and Taylor, District Judge.

The panel as constituted in the above case has voted to deny the petition for rehearing and to reject the suggestion for a rehearing in banc.

The full court has been advised of the suggestion for an in banc hearing, and no judge of the court has requested a vote on the suggestion for rehearing in banc. Fed.R.App.P. 35(b).

The petition for rehearing is denied and the suggestion for a rehearing in banc is rejected.

## APPENDIX D.

**U.S. Constitution, Amendment V—Capital Crimes; Double Jeopardy; Self-Incrimination; Due Process; Just Compensation for Property.**

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

## APPENDIX E.

**Stipulated Statement of Facts for Review.**

In the United States District Court for the Southern District of California.

In the Matter of Pasqual Patrick Piro, Jr., aka Pat Piro, dba Boys Towne, Bankrupt. In Bankruptcy No. 8368-LK.

Filed: March 2, 1971.

At San Diego, California, in the above District.

Lawrence Holzman, Trustee herein, and LHJ Enterprises, Inc., Applicant herein, by and through their respective attorneys of record, do hereby stipulate to the following statement of facts for use upon review of the Referee's Order dated November 30, 1970:

1. On March 10, 1970 the above-named bankrupt filed his petition in bankruptcy.

2. On March 13, 1970, Lawrence Holzman was appointed Trustee herein and has been at all times since that date acting as such.

3. On or about July 20, 1966, the above-named bankrupt (together with another individual), doing business as BOYS TOWNE, purchased from LHJ Enterprises, Inc. certain inventory of boy's clothing and fixtures located at 7644 Girard Avenue, La Jolla, California. At all times since that date the above-named bankrupt has been the owner of said inventory and fixtures.

4. On July 22, 1966, the bankrupt executed a promissory note, in favor of LHJ Enterprises, Inc., in the sum of $18,584.55 as part of the purchase price of such inventory of boy's clothing and fixtures. A copy of said promissory note is attached hereto as Exhibit "A".

5. To secure the payment of said $18,584.55 promissory note, the bankrupt executed a "security agreement" dated July 22, 1966, in favor of LHJ Enterprises, Inc. A copy of said security agreement is attached hereto as Exhibit "B".

6. On August 1, 1966, the bankrupt executed a financing statement (UCC-1) which was filed with the Secretary of State in Sacramento, California, on August 12, 1966. A copy of such financing statement is attached hereto as Exhibit "C".

7. At all times since July 20, 1966, and until March 2, 1970, the above-named bankrupt conducted a clothing business known as "BOYS TOWNE" at 4944 Newport Avenue, San Diego, California. During such time said bankrupt purchased additional items of inventory of boy's clothing for sale as part of the business of "BOYS TOWNE".

8. On April 17, 1970, Lawrence Holzman as Receiver, sold all of the right, title and interest of said Receiver and the bankrupt in the fixtures and boy's inventory of the business known as "BOYS TOWNE"; LHJ Enterprises, Inc., claiming a security interest in such personal property, stipulated in open court that the sale could be made free and clear of its claimed lien and that such lien, if any, be deemed to be transferred to the proceeds of the sale of said personal property.

9. For the purposes of this review, it is stipulated between the parties that the value attributable to inventory that existed as of July 22, 1966, shall be deemed to be $500.00.

10. No other security agreement or financing statement, or any other written document, was executed be-

tween said bankrupt and LHJ Enterprises, Inc., other than those described above.

Dated:

LUCE, FORWARD, HAMILTON & SCRIPPS

By: /s/ Theodore W. Graham
Attorneys for Lawrence Holzman, Trustee

HINCHY, KATZ, WITTE, WOOD & ANDERSON

By: /s/ Herbert Katz
Attorneys for LHJ Enterprises, Inc.

Stipulation Approved: March 4, 1971.

## APPENDIX F.

This FINANCING STATEMENT is presented for filing pursuant to the California Uniform Commercial Code

1. DEBTOR (LAST NAME FIRST): Piro, Pasqual
1A. SOCIAL SECURITY OR FEDERAL TAX NO.: 1 560 32 [illegible]
1B. MAILING ADDRESS: 4944 Newport Avenue
1C. CITY, STATE: San Diego, California
1D. ZIP CODE:
1E. RESIDENCE ADDRESS (IF AN INDIVIDUAL AND DIFFERENT THAN 1B):
1F. CITY, STATE:
1G. ZIP CODE:

2. ADDITIONAL DEBTOR (IF ANY) (LAST NAME FIRST): Johnson, Wesley E.
2A. SOCIAL SECURITY OR FEDERAL TAX NO.: 1 454-60-[illegible]
2B. MAILING ADDRESS: 4944 Newport Avenue
2C. CITY, STATE: San Diego, California
2D. ZIP CODE:
2E. RESIDENCE ADDRESS (IF AN INDIVIDUAL AND DIFFERENT THAN 2B):
2F. CITY, STATE:
2G. ZIP CODE:

3. DEBTOR (S) TRADE NAME OR STYLE (IF ANY): Boys Towne
3A. FEDERAL TAX NO.:
4. ADDRESS OF DEBTOR (S) CHIEF PLACE OF BUSINESS (IF ANY): 4944 Newport Avenue
4A. CITY, STATE: San Diego, California
4B. ZIP CODE:

5. SECURED PARTY: NAME: L.H.J. Enterprises, Inc.
MAILING ADDRESS: c/o Driscoll, Harmsen & Carpenter
CITY: San Diego STATE: California ZIP CODE: 92101
5A. SOCIAL SECURITY NO., FED. TAX NO. OR BANK TRANSIT AND A.B.A. NO.: 95-2110675

6. ASSIGNEE OF SECURED PARTY (IF ANY): NAME: MAILING ADDRESS: CITY: STATE: ZIP CODE:
6A. SOCIAL SECURITY NO., FED. TAX NO. OR BANK TRANSIT AND A.B.A. NO.:

7. This FINANCING STATEMENT covers the following types or items of property (if crops or timber, include description of real property on which growing or to be grown.) Inventory of boys' clothing now and hereafter contained in the premises at # 7644 Girard Street, La Jolla, California; and fixtures located at 7644 Girard Street, La Jolla, California, as listed on No. # 7 continued.

7A. Maximum amount of indebtedness to be secured at any one time (OPTIONAL): $

8. Check ☒ If Applicable: A ☐ Proceeds of collateral are also covered; B ☐ Products of collateral are also covered; C ☐ Proceeds of above described original collateral in which a security interest was perfected; D ☐ Collateral was brought into this State subject to security interest in another jurisdiction

9. (Date) 8-1- 1964

Pasqual Piro
Pasqual Piro
Boys Towne
By _____
SIGNATURE(S) OF DEBTOR(S) (TITLE)

Wesley E. Johnson
Wesley E. Johnson
L. H. J. Enterprises, Inc.
By _____
SIGNATURE(S) OF SECURED PARTY (IES) (TITLE) PRESIDENT

USCC 1 2 3 4 5 6 7 8 9

10. This Space for Use of Filing Officer (Date, Time, File Number and Filing Officer)
FILED
SACRAMENTO
CALIF.
AUG 12 1964 09 38
FRANK M. JORDAN
SECRETARY OF STATE

11. Return Copy to
NAME ADDRESS CITY, STATE AND ZIP
Driscoll, Harmsen & Carpenter
830 San Diego Trust & Savings
San Diego, California 92101

(2) FILING OFFICER COPY—ACKNOWLEDGMENT
Filing Officer is requested to note file number, date and hour of filing on this copy and return to the above party.
UNIFORM COMMERCIAL CODE—FORM UCC-1
Approved by the Secretary of State

## APPENDIX G.

### Security Agreement.

PASQUAL PIRO and WESLEY E. JOHNSON, a partnership, doing business as BOYS TOWNE, 4944 Newport Avenue, San Diego, California (hereinafter called "Debtor"), for valuable consideration, receipt whereof is hereby acknowledged, hereby grants to L. H. J. ENTERPRISES, INC., a California corporation, doing business as JOHNSON'S LTD., La Jolla, California (hereinafter called "Secured Party") a security interest in all of the inventory of boys' clothing and in fixtures designated in Exhibit A, which is attached hereto and made a part hereof, and any and all additions, accessions, and substitutions thereto or therefor (hereinafter called "Collateral"): to secure the payment of $18,584.55 as provided in the agreement between the parties hereto, for the sale of the Secured Party's inventory of boys' clothing and fixtures located at 7644 Girard Street, La Jolla, California, which agreement is dated July 20, 1966 and to further secure payment of $18,584.55 as provided in the note of Debtor of even date herewith and also any and all other liabilities of Debtor to Secured Party, direct or indirect, absolute or contingent, due or to become due, now existing or hereinafter arising, and to secure performance of all of the terms and conditions of the aforesaid agreement (all hereinafter called the "Obligations").

Debtor hereby warrants and covenants

1. That except for the security interest granted hereby Debtor is, or to the extent that this agreement states that the Collateral is to be acquired after the date hereof, will be, the owner of the Collateral free

from any adverse lien, security interest or encumbrance; and that Debtor will defend the Collateral against all claims and demands of all persons at any time claiming the same or any interest therein;

2. That the Collateral is not used or bought primarily for personal, family or household purposes;

3. That the Collateral will be kept at 7644 Girard Street, La Jolla, California.

4. That no Financing Statement covering any Collateral or any proceeds thereof is on file in any public office and that at the request of Secured Party, Debtor will join with Secured Party in executing one or more Financing Statements pursuant to the Uniform Commercial Code in form satisfactory to Secured Party and will pay the cost of filing the same in all public offices wherever filing is deemed by Secured Party to be necessary or desirable;

5. That Debtor will not sell or offer to sell or otherwise transfer the Collateral or any interest therein without the written consent of Secured Party;

6. That Debtor will have and maintain insurance at all times with respect to all Collateral against risks of fire (including so-called extended coverage), theft, and other risks as Secured Party may require and, in the case of motor vehicles, collision, containing such terms, in such form, for such periods and written by such companies as may be satisfactory to Secured Party, such insurance to be payable to Secured Party and Debtor as their interests may appear; that all policies of insurance shall provide for ten days' written minimum cancellation notice to Secured Party and at request of Secured Party shall be delivered to and held by it; and that Secured Party may act as attorney for Debtor

in obtaining, adjusting, settling and cancelling such insurance and endorsing any drafts;

7. That Debtor will keep the Collateral free from any adverse lien, security interest or encumbrance and in good order and repair and will not waste or destroy the Collateral or any part thereof; that Debtor will not use the Collateral in violation of any statute or ordinance; and that Secured Party may examine and inspect the Collateral at any time, wherever located;

8. That Debtor will pay promptly when due all taxes and assessments upon the Collateral or for its use or operation or upon this agreement or upon any note or notes evidencing the Obligations.

At its option, Secured Party may discharge taxes, liens or security interests or other encumbrances at any time levied or placed on the Collateral, may pay for insurance on the Collateral and may pay for the maintenance and preservation of the Collateral. Debtor agrees to reimburse Secured Party on demand for any payment made, or any expense incurred by Secured Party pursuant to the foregoing authorization.

Until default Debtor may have possession of the Collateral and use it in any lawful manner not inconsistent with this agreement and not inconsistent with any policy of insurance thereon.

Debtor shall be in default under this agreement upon the happening of any of the following events or conditions:

(a) default in the payment or performance of any obligation, covenant or liability contained or referred to herein or in any note evidencing the same;

(b) any warranty, representation or statement made or furnished to Secured Party by or on behalf of Debtor

proves to have been false in any material respect when made or furnished;

(c) any event which results in the acceleration of the maturity of the indebtedness of Debtor to others under any indenture, agreement or undertaking;

(d) loss, theft, damage, destruction, sale or encumbrance to or of any of the Collateral, or the making of any levy, seizure or attachment thereof or thereon;

(e) death, dissolution, termination of existence, insolvency, business failure, appointment of a receiver of any part of the property of, assignment for the benefit of creditors by, or the commencement of any proceeding under any bankruptcy or insolvency laws by or against, Debtor or any guarantor or surety for Debtor.

Upon such default and at any time thereafter Secured Party may declare all Obligations secured hereby immediately due and payable and shall have the remedies of a secured party under the Uniform Commercial Code. Secured Party may require Debtor to assemble the Collateral and make it available to Secured Party at a place to be designated by Secured Party which is reasonably convenient to both parties. Unless the Collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, Secured Party will give Debtor reasonable notice of the time and place of any public sale thereof or of the time after which any private sale or any other intended disposition thereof is to be made. The requirements of reasonable notice shall be met if such notice is mailed, postage prepaid, to the address of Debtor shown at the beginning of this agreement at least ten days before the time of the sale or disposition. Expenses

of retaking, holding, preparing for sale, selling or the like shall include Secured Party's reasonable attorneys' fees and legal expenses.

No waiver by Secured Party of any default shall operate as a waiver of any other default or of the same default on a future occasion.

All rights of Secured Party hereunder shall inure to the benefit of its successors and assigns; and all obligations of Debtor shall bind his heirs, executors or administrators or his or its successors or assigns. If there be more than one Debtor, their obligations hereunder shall be joint and several.

This agreement shall become effective when it is signed by Debtor.

This is a purchase money security interest.

DATED: July 22, 1966.

/s/ Pasqual Piro
Pasqual Piro
/s/ Wesley E. Johnson
Wesley E. Johnson

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IN THE

# Supreme Court of the United States

October Term, 1973
No. 73-247

LAWRENCE HOLZMAN, Trustee in Bankruptcy,
*Petitioner,*

*vs.*

L.H.J. ENTERPRISES, INC.,
*Respondent.*

## REPLY BY PETITIONER TO RESPONSE FILED BY RESPONDENT.

CHARLES J. KATZ,
3550 Wilshire Boulevard,
Suite 1720,
Los Angeles, Calif. 90010,
*Attorney for Petitioner.*

KATZ, HOYT & BELL,
LUCE, FORWARD, HAMILTON &
SCRIPPS,
*Of Counsel.*

Parker & Son, Inc., Law Printers, Los Angeles. Phone 724-6622

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LAWRENCE HOLZMAN, Trustee in Bankruptcy,
*Petitioner,*

*vs.*

L.H.J. ENTERPRISES, INC.,
*Respondent.*

## REPLY BY PETITIONER TO RESPONSE FILED BY RESPONDENT.

*To the Honorable Members of the United States Supreme Court:*

The Respondent has now filed its response to the petition for the Writ of Certiorari. By that response it disputes none of the facts and indeed none of the law as asserted by petitioner. Instead Respondent says merely that the grounds here urged by petitioner for the writ were not heretofore raised in the Court below. The Respondent is in error. The Petition for Rehearing filed by petitioner in the Ninth Circuit Court of Appeals (a copy of which is hereunto annexed) contained the same three questions, substantially, as are now urged here for the granting of the writ. Furthermore the one case cited by respondent *i.e., Hormel v. Helvering,* 312 U.S. 552 (1941), appears to be opposed to Respondent's argument here. (See particularly the opinion of Mr. Justice Black for the Court at page 557.)

None of the circumstances justifying the application of the doctrine asserted by respondent is present here because substantially the same three questions herein were in fact raised in the Circuit Court, and they are raised, and their merits are exhibited, in the petition for certiorari and none has ever been expressly waived. The petition for certiorari makes clear the miscarriage of justice that would result if this Court does not consider the questions here presented.

We submit that for all the reasons set forth in the petition, that the Writ of Certiorari should issue, or that the decision below should now be reversed on the record here made.

Respectfully submitted,

CHARLES J. KATZ,
By CHARLES J. KATZ,
*Attorney for Petitioner.*

KATZ, HOYT & BELL,
LUCE, FORWARD, HAMILTON &
SCRIPPS,
*Of Counsel.*

**APPENDIX.**

No. 72-1208

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

LAWRENCE HOLZMAN, Trustee in Bankruptcy,

*Appellant,*

*vs.*

L.H.J. ENTERPRISES, INC.,

*Appellee.*

---

**1. Petition for Rehearing.**
**2. Suggestion That Cause Be Heard En Banc.**

---

**Prefatory Statement.**

The decision here made upholds as valid against a trustee in bankruptcy, a general roving purchase money security interest upon the proceeds of the future acquired inventory of a retail merchant; and, it does so in the setting of a filed financing statement which does *not* disclose upon its face that a lien upon the proceeds of any such future acquired inventory is claimed by the secured party.

Because of its broadly pervasive effect upon both commercial and bankruptcy law, and its potential for clash with the due process clause of the Federal Constitution, it is respectfully suggested that if there be a rehearing ordered, that then it be reheard en Banc.

The case was heard and reviewed on a stipulation of facts and involves purely questions of State Commercial and Bankruptcy Law.

**Grounds for Rehearing.**

I.

The financing statement as filed here expressly *does not cover* the proceeds of the after acquired collateral (and expressly *does not even cover the proceeds* of the original collateral); it is thus violative of the standard established by Commercial Code 9402 for financing statements.

II.

The purchase money security interest exemption from the statutory prohibition (Commercial Code 9102 (4)) against inventory liens of a retail merchant in California, means a *purchase money security interest in the inventory of a retailer which is actually sold (or specifically financed by the secured party) to that retailer.* As a *purchase money* security interest, it does not mean, for it cannot by its own terms mean, a purchase money security interest in the goods sold to the retailer by third party vendors, such as the creditors here.

III.

As here construed, and as here applied to after acquired proceeds, Commercial Code Section 9102(4) unconstitutionally deprives the creditor-vendors of this bankrupt, of their interests in property, without due process of law, contrary to the Fifth and Fourteenth Amendments to the Federal Constitution.

**Summary Statement of Facts.**

Briefly stated, the admitted facts are: The bankrupt was a retail merchant of boys' clothing; in July 1966 he bought an inventory of boys' clothing and retail store fixtures from appellee, giving back a note evidencing a portion of that purchase price; and, to secure that note a security agreement was signed [TR 15] giving appellee, a "purchase money security interest" in all of the inventory of boys' clothing and designated fixtures; and, in:

> "ANY AND ALL ADDITIONS, ACCESSIONS AND SUBSTITUTIONS THERETO AND THEREFOR."

A financing statement was then filed with the Secretary of State [TR 24]. It recites:

> "THIS FINANCING STATEMENT COVERS THE FOLLOWING TYPES OR ITEMS OF PROPERTY (. . .): INVENTORY OF BOYS' CLOTHING NOW AND HEREAFTER CONTAINED IN THE PREMISES."

The financing statement here filed [TR 24] expressly *does not* cover the proceeds of any collateral. As appears from its face, provisions are there made, (on the form prescribed by the Secretary of State of California (at paragraph 8 thereof)) for the secured party and debtor to declare expressly whether the "Proceeds of Collateral are also covered." This is done by so indicating by a required check mark in the box alongside the printed phrase, ("Proceeds of Collateral are also cov-

ered"). Neither the secured party, nor the debtor, so indicated upon the face of that filed financing statement [TR 24].

In the intervening four years between 1966 and 1970 (the year of the Bankruptcy) the bankrupt made substantial purchases from other vendors, now unpaid creditors herein, of different inventory than that originally sold by the Appellee. By their Stipulation of Fact, the parties agreed that only $500.00 in value of the 1966 inventory was on hand in 1970 [TR 11]. The Trustee in 1970 sold the bankrupt's inventory for more than $4,143.92 plus interest; that was the amount still owing appellee in 1970 on his 1966 indebtedness. Believing appellee to have a valid purchase money security in all the *proceeds* of that after acquired inventory, the Court below awarded the appellee the full amount of its indebtedness out of the Receivers' sales proceeds, rather than allowing appellee only the value of the remainder of the original property which appellee had first sold to the bankrupt. This Court affirmed.

## ARGUMENT.

### I.

### The Essential Question Is Whether in This Bankruptcy Setting the Filed Financing Statement Meets, or Fails to Meet, the Standard, Imposed by Section 9402 Commercial Code, When Read in the Light of Its Purpose, and Read in the View of Sections 9102(4) and 9306 of the Commercial Code.

We are told on all sides that the most novel feature of the Uniform Commercial Code respecting secured transactions, is its substitution of a unitary security device, the filed financing statement, for the great many personal property security devices otherwise in use during the pre-commercial code years. (42 Oregon Law Review 1; 8 U.C.L.A. Law Review 806.)

Except only for this filed financing statement, there are today no other recording or notice requirements in the commercial law field. Insofar as public records are concerned only and solely by inspection of the filed financing statement can an existing or potential creditor have the opportunity to inform himself of whether, and of the extent to which, an existing or prospective debtor has encumbered his assets, and to govern himself accordingly in dealing with that debtor. (Com. Code 9407; *In re Thomas* (9 Cir.) 466 F.2d 51; *Lines v. Bank of California* (9 Cir.) 467 F.2d 1274.)

In the case at bench such a creditor inspecting this particular financing statement in 1969 or early 1970, would have learned that the financing statement covered the following types or items of property: "Inventory of boys clothing now and hereafter contained in the premises at 7644 Girard Street, LaJolla, California.", and the prospective creditor would have learned that the secured

party did *not* claim that the *proceeds* of the then or thereafter acquired inventory were covered by the Security Agreement. And he would not have learned from inspecting the financing statement itself that it granted the appellee a purchase money security interest in that inventory.

The question of the sufficiency of a filed financing statement has been before this Court in the recent cases of "*In re Thomas*" and "*Lines v. Bank of California*", *supra.* In *Lines* this Court held the failure of the financing statement to list the residence address of the debtor was inconsequential, so long as his business address was shown thereon. In *Thomas* this Court held the failure of the financing statement to show the debtor's real name, was fatal, even though the fictitious business firm name was disclosed, and even though creditors assertedly knew the debtor by that fictitious business firm name.

Here the failure on the face of the financing statement to affirmatively assert that the *proceeds* of the collateral were claimed, is surely not inconsequential. A creditor ought, with certainty, to know whether or not a secured creditor claims the proceeds of the specified collateral. If it were assumed *per se* that proceeds were always claimed, or covered, whenever personal property collateral is claimed, then there would be no reason for the elaborate provisions of Section 9306 of the Commercial Code, which define very carefully when *proceeds* are a part of the collateral itself, and when *they are not* (*cf.* subsections (1) and (2)); and define equally carefully when no right to *proceeds* of collateral exists in favor of the holder of the collateral itself (9306(3)); and, the same section 9306 specifically describes when the original rights to such *proceeds* are lost (9306(4)).

One need only glance at the following portions of Sec. 9306 to realize that the proceeds of collateral are not necessarily an inseparable adjunct of collateral; indeed even a casual glance at the following will reveal that *proceeds* are, in fact, separable and separate from the collateral: "9306 [Proceeds: Secured Party's Rights on Disposition of Collateral]:

"(3) The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected, but it ceases to be a perfected security interest and becomes unperfected 10 days after receipt of the proceeds by the debtor unless

(a) A filed financing statement covering the original collateral also covers proceeds; or

(b) The security interest in the proceeds is perfected before the expiration of the 10 day period.

(4) In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest.

(a) In identifiable noncash proceeds and in a separate bank account containing only proceeds;

(b) In identifiable cash proceeds in the form of money which is not commingled with other money or deposited in a bank account prior to the insolvency proceedings;

(c) In identifiable cash proceeds in the form of checks and the like which are not deposited in a bank account prior to the insolvency proceedings; and,

(d) In all cash and bank accounts of the debtor in which proceeds have been commingled

with other funds, but the perfected security interest under this paragraph (d) is

(i) Subject to any right of setoff; and

(ii) Limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before the institution of the insolvency proceedings less the sum of (I) the payments to the secured party on account of cash proceeds received by the debtor during such period and (II) the cash proceeds received by the debtor during such period to which the secured party is entitled under paragraphs (a) through (c) of this subdivision (4)."

Nor is appellee's right, *per se,* to the proceeds of the collateral any stronger because the security agreement by its terms grants appellee a security interest in the *accessions* to the original inventory [TR 15]. The elaborate provisions in Section 9314 deal with a security interest in such accessions to goods; there in subsection (3) the legislature has provided that such a security interest in accessions to goods, *does not take priority over*

"(b) A creditor with a lien on the whole subsequently obtained by judicial proceedings."

And, of course, the Trustee in bankruptcy is that idealized hypothetical lien claimant as at the date of bankruptcy. (11 U.S.C. 110 (c); *Sequoia v. Jarret* (9 Cir.) 410 F.2d 1116, 1119; *In re Thomas, supra.*

Interesting in this regard is subsection (4) of Section 9204:

"(4) No security interest attaches under an after acquired property clause (b) to consumer

> goods other than accessions (Section 9314) or replacements when given as additional security unless the debtor acquires rights in them *within ten days* after the secured party gives value."

Surely we would reach a bizarre result here if the "after acquired" property clause of the particular security agreement made at the time of the original inventory sale in 1966, somehow attached to the consumer goods (boys' clothing) sold this bankrupt in 1969 and 1970 by other creditors.

And that a claim to collateral *does not per se carry with it a claim to the proceeds of that collateral* is made crystal clear in the study entitled "California Chattel Security and Article Nine of the Commercial Code." (8 U.C.L.A. Law Review 806, at p. 878) where we are taught that:

> "NO SUCH PERFECTED SECURITY INTEREST WILL AUTOMATICALLY ARISE AS TO PROCEEDS UNDER THE CODE UNLESS THE FILED FINANCING STATEMENT COVERING THE ORIGINAL COLLATERAL ALSO STIPULATED PROCEEDS."

It has been suggested here that a purchase money security interest in after-acquired inventory of a merchant which does not *per se* cover the proceeds of that inventory, is a "contradiction in terms". This argument, we suggest is not necessarily true. Thus a retail jewelry inventory might consist of valuable diamonds. Would it necessarily follow that an inventory lien on the *res*, would be commercially *useless*, unless the lien *per se* (and without express declaration to that effect) was construed to apply to the proceeds of those same diamonds? And what of a retail art dealer selling paintings

by Picasso or Renoir? Would not an inventory lien on that inventory be commercially useful, without reading into the purchase money security interest in the pictures, a claim to the proceeds of the sale thereof? Similar examples can be multiplied endlessly.

Nor need we speculate at all here that the parties expressly agreed by their security agreement that proceeds were intended to be covered [TR 15-20]. Instead, by their security agreement, they agreed:

> "Debtor hereby warrants and covenants:
>
> 5. *That Debtor will not sell or offer to sell or otherwise transfer the collateral* or any interest therein without the written consent of Secured Party" (no such consent is shown).

And the security agreement further provides:

> "Until default Debtor may have possession of the collateral and use it in any lawful manner not inconsistent with this agreement, and not inconsistent with any policy of insurance." [TR 17-18].

And it is expressly declared an act of default by the debtor, if the debtor sells the collateral. Thus, the Security Agreement provides:

> "Debtor shall be in default under this Agreement upon the happening of any of the following events or conditions: . . . (d) Loss, theft, destruction, *sale* or encumbrance to or of any of the collateral . . ."

With such a Security Agreement prohibiting sales of the collateral in the first instance, and declaring it to be an event of default if there were such a sale, it cannot, we submit, be said that the financing statement as filed

must be construed, *per se,* to cover proceeds of the sale of after acquired inventory. This is certainly true when, as here, the filed financing statement made no such claim to proceeds.

Perhaps, arguendo, the parties could have executed a purchase money security agreement expressly covering (subject to bankruptcy and constitutional limitations) the proceeds of sales of goods sold by third parties to the retailer; and, could have filed a financing statement expressly covering the proceeds of such after acquired goods. But the short answer here is That They Did Not Do So. What Justice Hufstedler, speaking for this Court in *DuBay v. Williams,* 417 F.2d 1277, 1288, said about a like situation where the agreement, as drawn by the parties, failed to meet the applicable legal standards, is here apposite: "*They (*i.e. the parties) *could have done so, but they did not, and we cannot draw for them an agreement they did not draw for themselves.*"

II.

**The Phrase "Purchase Money Security Interest" Is Not an Esoteric Term. It Is Clearly Defined in the Commercial Code 9107. It Is Not Necessary to Read It Either Broadly or Narrowly; It Is Necessary to Read It Carefully. Since We Deal Here With the Seller of the Collateral, the Appellee, and the Purchaser, the Bankrupt, We Deal With Subsection (a) of 9107:**

"9107. Definitions: 'Purchase Money Security Interest'. A security interest is a 'purchase money security interest' to the extent that it is

(a) Taken or retained by the seller of the collateral to secure all or part of its price; . . ."

Thus, by the code definition a security interest is only a "purchase money security interest" limited *to the extent* that is taken by the *seller* of the collateral to secure the price.

The principle here asserted is consistent with the note found in West's Annotation to Section 9107: "Its (i.e. the purchase money security interest) counterpart under prior California law was" the purchase money mortgage or security interest purchase money "deed of trust". *Roseleaf v. Chierighino*, 59 Cal.2d 35 and *Sosna v. Baranow*, 242 Cal.App.2d 460 make crystalline the point and the distinction here made. In *Sosana* at page 464: "The case of *Roseleaf Corp. v. Chierighino* (59 Cal.2d 35) holds that a trust deed securing a note executed by a vendee to the vendor for part of the purchase price which encumbered property other than the property purchased is not a purchase money deed of trust".

Appellee thus may have a purchase money security interest *in the goods which appellee sold to the bankrupt to secure the price. Appellee cannot have a purchase money security interest upon goods which it never sold at all to the bankrupt, but which third parties instead sold.* In the setting of this case, unless appellee was the seller of the *goods on hand* at the date of bankruptcy it could never have a purchase money security interest therein, at all.

III.

**The Net Result of the Within Decision, Is to Transfer, Without Just or Any Compensation, the Interests of the General Creditors Who Sold Goods Which Were a Part of the Inventory on the Date of Bankruptcy, to One Who Was Never the Seller of Those Goods, but Who Has Nevertheless Now Been Enabled Successfully to Claim the Rights of Such a Seller. That Result Is the Direct Consequence of the Present Application and Construction of Commercial Code Sections 9107(a) and 9102(4).**

Such a result is contrary both to the Fifth and Fourteenth Amendments to the Federal Constitution, and particularly to the due process and equal protection of the law clauses thereof.

Since the construction and application here made of these Statutes collide so patently with these Federal guarantees, and since the construction and application of these Statutes suggested here by Appellant avoid such constitutional collision, the latter construction ought to be followed. (*American Power and Light v. S.E.C.*, 329 U.S. 90, 107, 8; *City of Los Angeles v. Belgrade*, 42 Cal.2d 823, 832.)

A rehearing is requested.

LUCE, FORWARD, HAMILTON & SCRIPPS,
GITELSON, KATZ, HOYT & BELL,
By CHARLES J. KATZ,
*Attorneys for Appellant-Petitioner Herein.*

I, Charles J. Katz, attorney for Appellant-Petitioner do hereby certify that the foregoing petition for a rehearing of this cause is presented in good faith and not for purpose of delay.

CHARLES J. KATZ,
*Attorney for Appellant-Petitioner.*

CERTIORARI DENIED